

C 5800-11

Economics Department

McGraw-Hill Publications Company

1221 Avenue of the Americas
New York, New York 10020

Eric B. Herr

Vice President, Economics

Copyright by McGraw-Hill
Further reproduction
prohibited.

November 1979

THE U.S. BUSINESS OUTLOOK

Although some economic indicators pointed upward in the third quarter of 1979 and raised questions as to whether the much-heralded recession will in fact occur, our view is that indeed it will.

More specifically, we expect real gross national product to decline next year by $1\frac{1}{2}\%$, with the first half bearing the brunt. The reason for this outlook, in broad terms, is twofold: Shortrun cyclical excesses--such as huge debt-driven consumer spending--will undergo correction next year; and in addition, America's longrun energy and inflation problem will continue to throttle economic growth.

On the inflation front, we expect that despite the 1980 slowdown, prices will rise by 9% next year, uncomfortably high especially in the face of expected increases in the unemployment rate.

This high inflation-high unemployment situation will create a policy dilemma for the Administration, adding to the political uncertainty of an election year. The Administration and Congress would break the precedents of the post-Depression era were they not to tilt towards fiscal stimulation, again fueling the inflationary fire. Some tax cut is almost certain. At issue is its size.



The Long-Term Problems

For almost a decade, the U.S. economy has been afflicted by two related diseases--high and rising energy costs, and inflation. And regardless of the cyclical adjustments which must take place next year, this twin fever will continue to weaken the economy in 1980.

One of the most serious consequences of the energy and inflation problem is that it has increased uncertainty among business decision makers. In a higher-risk environment, firms and investors have trouble predicting future states of the economy and they therefore tend to take the safe, conservative route: They restrain commitments to the future and concentrate on shortrun stratagems. One result is slower growth, as for example when firms skew their budgets away from capital spending.

In addition to increasing the riskiness of longterm commitments, high and rising energy costs and inflation together have

- . increased instability in international currency markets, raising the costs of doing business internationally,
- . depressed consumer confidence, and
- . raised the cost of domestic capital.

Briefly, energy and inflation have contributed heavily to gyrations in international money markets. And resulting doubts about the relative values of currencies have made it more difficult to gauge the costs and revenues of business endeavors. Consumers, for their part, have been quick to learn that in inflationary times buying sooner rather than later pays off and that borrowed money is relatively cheap. Thus, they've stepped up purchases by chopping two percentage points off their savings rate of the early 1970's and by going into debt. Finally, inflation hikes the cost of domestic capital by increasing risk,

which means higher interest rates and lower price/earnings ratios. Thus, the external financing costs facing firms rises, raising the opportunity cost of internal funds.

Cyclical Excesses

From 1976 to 1978 the amount of consumer installment credit rocketed by nearly 50% to \$298 billion. Meanwhile, less and less of the debt was being paid off, so that the net change in outstanding credit more than doubled during the period. In 1979, the consumer continued to pile up big debts. And, compared to disposable personal income, households' net increase in liabilities jumped from 8% in 1976 to 11% in 1978.

From 1976 to 1978 consumers also reduced the relative proportion of income saved, the rate falling from 5.8% in 1976 to 4.9% in 1978. The saving rate rose somewhat during the first half of 1979, but in the third quarter it plummeted to 4.1%. Moreover, real disposable personal income dropped by 0.6% at an annual rate from the first to the third quarter.

Putting the runup in debt and the rundown in savings together points to the conclusion that consumer spending at 1979 levels is unsustainable. In addition, if the Federal Reserve Board sticks to its credit tightening policy consumers will be forced to reduce their borrowing whether or not they consider their balance sheets out of whack. With consumption comprising about two-thirds of gross national product, it's evident that the correction will have a large impact on the economy next year.

In addition, the super-high interest rates caused by the Fed policy will particularly hit the housing sector as mortgage rates jump and thrift institutions

lose funds via disintermediation. House buying will also be damped by consumer debt load correction.

While the immediate purposes of the Fed action were to shore up the dollar and tighten credit, the longer term hope is that the upward spiral of inflationary expectations can be broken. To state it another way, the Fed action can be viewed as an attempt to correct the cyclical excess of money creation, an excess which has created the inflationary expectations which in turn feed into more rush buying and yet higher prices.

Money growth accelerated sharply in 1976 and then moderated or fell over the next two years, depending on what measures of the money stock you look at. But, taking M1 as an example, even this moderation produced money growth of 7%-8%, twice the rate of growth in the period just prior to U.S. involvement in Vietnam. Money growth rates then declined during the first part of 1979, but shot up again in the second half of the year.

In this context, and with inflation running at more than a 13% annual rate and the dollar under fire, the Fed made its move. We assume the Fed will stick to its guns through the first half of 1980, so that higher interest rates and tighter credit will restrain economic activity. As election time approaches and recession visibly impacts the economy, however, pressure will mount for the Fed to loosen its grip on the money supply.

The Fed policy will at the same time have an impact on employment, which will be particularly vulnerable in 1980 because during the recent expansion jobs were created at an extraordinary rate. In fact, in strictly economic terms, it could be said that job creation was excessive, in the sense that firms chose to increase output by increasing manpower rather than by adding plants and equipment.

From 1974 to 1978, real growth in GNP was nearly 15%, nonagricultural employment grew by 9 $\frac{1}{2}$ %, and real spending on plants and equipment grew not at all. According to our 26th Annual Preliminary Survey of U.S. Business' Plans for New Plants and Equipment, firms plan about a 7% increase in real capital spending in 1979, but next year they expect no real gains in capital expenditures. Meanwhile, the rate of job creation has slowed this year compared to the previous three years, and we expect employment to suffer next year as firms faced with soft demand correct their "excess" job creation.

We also expect that firms next year will have to do some correcting of excessive inventories. The reason is that business typically enters a downturn in an overly optimistic frame of mind, and consequently gears up for sales which don't materialize. As an example of this phenomenon, McGraw-Hill's Fall capital spending survey reports that while manufacturers expect recession or slow growth in 1980 (say, 1% real growth at best), at the same time they expect their real sales to grow by 3%.

It is expected, too, that some capital projects will be abandoned or pared down next year as the recession unfolds.

With the consumption and investment sectors providing no strength next year, is there any hope for help from net exports?

The fall in the value of the dollar should improve the price competitiveness of U.S. exports, and a weakened economy next year should damp the demand for imports. Thus, on the face of it, there should be some improvement in the U.S. balance of trade. However, with OPEC apparently bent on sending oil prices further into the stratosphere, the U.S. oil bill--comprising about one-fourth of total import expenditures--will jump again. Thus, we will witness another scene in the longrunning drama of how the U.S. transfers income abroad.

If the above assumptions are correct, unemployment will be rising and activity will be falling as the economy moves through the first half of 1980. Add the fact that 1980 is an election year, and government action looks very likely. We expect that Congress will enact a tax cut to spur the economy, and that the Fed will give in to pressure to ease up on interest rates and the money supply. These policies will provide a shortrun uptick to growth, but will also contribute, with a lag, to inflation.

Summary

Overspending by consumers, overemploying by business, and other economic excesses are coming to a head and are due for a correction. That correction is expected to have its major impact on the first half of 1980, sending the annualized rate of growth to -5.1% in the first quarter and -3.4% in the second quarter.

Meanwhile, continuing energy and inflation problems will restrain the economy next year, and will help damp recovery in the second half. Energy and inflation problems, furthermore, are expected to persist over the foreseeable future. On the inflation side, one major element in 1980 will be wages catching up with inflation. Energy, too, will of course be an inflationary factor next year, as OPEC's hand is strengthened by the uncertainty of oil supplies from Iran. Possible supply shortfalls will also place additional restraint on economic activity in the U.S. The risks, then, are skewed toward the downside next year.

Short term, therefore, the outlook is for negative growth followed by a sluggish rebound in 1980, accompanied by rising prices and unemployment. Longer term, our view is that inflation and energy will continue to be the key stumbling blocks of the economy. The implication is that this twin onus will prevent the economy from entering a period of strong growth.

NATIONAL PRODUCT ACCOUNTS AND KEY ECONOMIC INDICATORS
(Billions of Dollars)

	-----Actual-----		-----Forecast-----				-----Annual-----		
	1979		1979	1980			1977	1978	1979
	2Q	3Q	4Q	1Q	2Q	3Q			
National Product Accounts									
Gross National Product	2329.8	2395.4	2434.3	2453.5	2483.7	2543.7	1899.5	2127.6	2362.9
Consumer Spending	1475.9	1527.7	1558.0	1580.0	1606.9	1652.8	1210.0	1350.8	1504.0
Gross Private Domestic Investment	395.4	393.7	388.8	379.5	372.4	377.0	303.3	351.5	388.9
Fixed Investment	361.9	378.4	381.0	379.5	373.4	376.0	281.3	329.1	369.5
Nonresidential	249.1	262.0	266.0	268.0	266.7	268.0	189.4	221.1	255.6
Residential	112.9	116.4	115.0	111.5	106.7	108.0	91.9	108.0	113.9
Inventory Change	33.4	15.3	7.8	0.0	-1.0	1.0	21.9	22.3	19.4
Government Purchases	466.6	477.5	490.5	497.0	506.9	516.6	396.2	435.6	473.7
Federal	161.7	162.7	168.5	169.5	173.0	176.4	144.4	152.6	164.1
State & Local	304.9	314.8	322.0	327.5	333.9	340.2	251.8	283.0	309.6
Net Exports	-8.1	-3.5	-3.0	-1.5	0.0	0.5	-9.9	-10.3	-2.7
Real GNP (1972 dollars)	1422.3	1434.4	1426.0	1407.5	1395.6	1400.2	1340.5	1399.2	1428.3
(% change annual rates)	-2.3	3.5	-2.3	-5.1	-3.4	1.3	5.3	4.4	2.1
Implicit Price Deflator									
(% change annual rates)	9.3	8.0	9.2	9.0	8.8	8.7	6.0	7.3	8.8
Key Economic Indicators									
Unemployment Rate (percent)	5.7	5.8	6.2	7.2	7.8	7.9	7.0	6.0	5.9
Housing Starts (thousands of units)	1834	1825	1730	1525	1460	1500	1987	2020	1751
Consumer Price Index									
(% change annual rates)	13.6	12.9	12.8	10.5	9.5	9.5	6.5	7.7	11.2